REPORT OF THE

OFFICE OF THE AUDITOR GENERAL

TO THE

JOINT LEGISLATIVE AUDIT COMMITTEE

001

COST SAVINGS AVAILABLE THROUGH VOLUME PURCHASING IN THE MEDI-CAL PROGRAM

APRIL 1980

California Legislature

Joint Legislative Audit Committee

GOVERNMENT CODE SECTION 10500 et al

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April 15, 1980 001

The Honorable Speaker of the Assembly
The Honorable President pro Tempore of the Senate
The Honorable Members of the Senate and the
Assembly of the Legislature of California

Members of the Legislature:

Your Joint Legislative Audit Committee respectfully submits the Auditor General's report concerning available cost savings through volume purchasing in the Medi-Cal program.

The report finds that potential savings to the Medi-Cal program of at least $16.1 million are available through volume purchasing prescription drugs, eyeglasses, and laboratory services. The report also indicates the nature of the concerns the opticians, optometrists, pharmacists, pharmaceutical manufacturers, and clinical laboratory technicians have expressed regarding Department of Health Services' volume purchase proposals.

The report highlights the legal issues concerning volume purchasing and indicates areas where legislative action is required.

The auditors are Richard C. Mahan, Audit Manager; Steven L. Schutte; Walter M. Reno; and Andrew P. Fusso.

Respectfully submitted,

S. FLOYD MORI
Chairman, Joint Legislative
Audit Committee

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SUMMARY

Medi-Cal is a $4.1 billion program funded jointly by the State and the Federal Government. The program, authorized by Title XIX of the Social Security Act and Section 14000 et seq. of the Welfare and Institutions Code, provides health services to Medi-Cal eligibles and low-income Californians. Approximately 2.9 million persons qualify for services each month. Under the program, beneficiaries are entitled to a variety of services, including prescription drugs, eyeglasses, durable medical equipment, medical transportation services, and laboratory services.

California controls the costs of these services with maximum allowances. In an attempt to reduce costs, the Department of Health Services has sought alternative methods of delivering health services. Volume purchasing is one such alternative. Although the department has formulated proposals for purchasing prescription drugs, eyeglasses, and laboratory services in volume, none has been implemented.

We reviewed the department's volume purchasing studies and compared current Medi-Cal commodity prices with prices paid by other government organizations which contract

for these commodities. Based on these studies, we calculated that the department could save

- $5.6 million to $6.9 million annually by contracting for prescription drugs and by obtaining prices comparable to those obtained by Los Angeles County or the State Procurement Office;

- Approximately $3.0 million annually by contracting for eyeglasses and by obtaining prices similar to those paid by Washington State's Department of Social and Health Services;

- Approximately $7.5 million annually by contracting for laboratory services.

In view of these savings, we recommend that the Department of Health Services undertake pilot projects to evaluate the feasibility of volume purchasing.

INTRODUCTION

In response to a resolution of the Joint Legislative Audit Committee, we have examined the potential for cost savings through volume purchasing of certain commodities and services for Medi-Cal beneficiaries. This review was conducted under the authority vested in the Auditor General by Section 10500 et seq. of the Government Code.

Medi-Cal is a $4.1 billion program funded jointly by the State and the Federal Government. This program pays for the health services received by persons eligible for Medi-Cal and by low-income Californians. On the average, approximately 2.9 million persons qualify for services each month. Known as Medicaid in other states, the program is authorized by Title XIX of the Social Security Act and Section 14000 et seq. of the Welfare and Institutions Code. For fiscal year 1979-80, the State's share of Medi-Cal expenditures is approximately 56 percent, and the federal share, 44 percent.

Medi-Cal beneficiaries are entitled to a variety of services rendered by professional health care providers. Providers include health clinics and individuals which supply physicians' office care, dental services, drugs, inpatient and outpatient hospital services, nursing home care, and other health-related services to beneficiaries.

Background of Volume Purchasing Proposals

Presently, the Department of Health Services (DHS) pays Medi-Cal providers their retail cost up to a maximum amount for commodities and services used by beneficiaries. During 1978, Medi-Cal paid $145.6 million for prescription drugs, $17.5 million for eyeglasses, and $50.6 million to physicians and clinical laboratories for tests on behalf of recipients. In an attempt to reduce costs, Medi-Cal has sought alternative methods of delivering health services. Volume purchasing is one such alternative. Under a volume purchasing plan (VPP), Medi-Cal would contract for certain medical commodities and services, using its volume of business as leverage to obtain lower prices from wholesale or retail providers.

In November 1974, the Department of Health Services organized a task force to study the feasibility of implementing a volume purchasing program for drugs. Upon completing its study, the task force presented recommendations which led to the formation of a VPP unit in February 1975. This unit concentrated on developing a plan for purchasing prescription drugs. While its original proposal provided for central procurement of drugs, it was later changed to a plan in which manufacturers would provide the State with a rebate for purchasing their products. The unit selected this alternative

to reduce the complexities and high administrative costs associated with the original plan.

In 1977, the department attempted to start a VPP pilot project for drugs but was unable to obtain legislative approval and subsequently cancelled this project. Although DHS has since developed additional proposals for purchasing eyeglasses and nonemergency outpatient laboratory tests in volume, it had not been able to implement these or any other Medi-Cal volume purchasing projects at the time of our review.

The Federal Government has also expressed interest in volume purchasing. A General Accounting Office report entitled, Savings Available by Contracting for Medicaid Supplies and Laboratory Services (July 6, 1978), recommended that the Department of Health, Education, and Welfare (HEW) encourage states to competitively purchase eyeglasses, oxygen, wheelchairs, and such common items of equipment to the extent permitted by existing law. At about the same time that GAO was studying competitive purchases of medical equipment, HEW was reviewing the benefits of volume purchasing plans. In May 1979, HEW proposed regulations for purchasing eyeglasses and hearing aids in volume. These regulations, which should be completed by June 1980, would apply to the Medi-Cal program.

* Public Law 96-88 reorganized the Department of Health, Education, and Welfare. Beginning in April 1980, the federal agency responsible for Medicaid programs will be the Department of Health and Human Services.

Scope and Methodology

During this review, we examined the feasibility of volume purchasing as it relates to selected commodities within the Medi-Cal program. Specifically, our study included

- A review of DHS' volume purchasing studies involving prescription drugs, eyeglasses, and laboratory services;
- A comparison of Medi-Cal's prices with those of entities which use volume purchasing for prescription drugs and eyeglasses;
- An examination of Medi-Cal provider concerns regarding volume purchasing.

We conducted fieldwork at the Sacramento headquarters of the Department of Health Services and at the Office of State Procurement of the Department of General Services. In addition, we visited Los Angeles County and the State of Washington. During the course of our review, we also contacted officials of professional associations which represent various Medi-Cal providers.

STUDY RESULTS

MEDI-CAL COULD OBTAIN SIGNIFICANT COST SAVINGS THROUGH VOLUME PURCHASING

The State could save the Medi-Cal program $16.1 million annually if it used competitively bid or negotiated contracts statewide to volume purchase prescription drugs, eyeglasses, and laboratory services provided to Medi-Cal beneficiaries.* The state Office of Procurement, the County of Los Angeles, and Medicaid programs in other states use direct contract methods to volume purchase these commodities and services at lower prices than those paid by the Medi-Cal program. However, the Department of Health Service's ability to institute such procedures has been limited by provider concerns and by legal constraints. Pilot projects would provide the department an evaluation of these concerns and constraints before a volume purchasing program is adopted statewide.

Potential Savings Through Volume Purchasing Prescription Drugs

The Department of Health Services currently controls prescription drug costs of the Medi-Cal program by paying a

* The level of potential savings available is an estimate based on the assumption that through volume purchasing Medi-Cal could obtain prices similar to those obtained by agencies in California and in other states.

pharmacist a dispensing fee and the wholesale cost of drugs up to a maximum amount. If DHS contracted directly with pharmaceutical manufacturers, it could obtain annual savings of approximately $5.6 to $6.7 million.

Pharmacists obtain drugs directly from pharmaceutical manufacturers or wholesalers. After filling a Medi-Cal prescription, the pharmacist bills the Department of Health Services. The department then reimburses the pharmacist for the ingredient cost (up to a maximum amount) and a dispensing fee.

Under the volume purchase proposal, DHS would contract directly with the pharmaceutical manufacturers for the 50 to 75 multi-source drugs which require the greatest reimbursement to providers. The pharmacist's procedures would remain unchanged except when preparing the contracted drugs. For these drugs, the pharmacist would be reimbursed only for the contracted brand names unless the department gave prior authorization to substitute a comparable drug. DHS would pay ingredient costs and dispensing fees to pharmacists and would then bill the pharmaceutical manufacturers for the rebate.

DHS analyzed the proposed system using fiscal year 1975-76 data which had been adjusted to fiscal year 1977-78 amounts. In the analysis, the department assumed contracting

would save 20 percent on drug costs for a total savings of $9.7 million. DHS deducted from this figure the estimated additional administrative costs of $1.1 million, yielding a net savings of $8.6 million.

We compared the prices DHS paid for drugs during fiscal year 1977-78 with those paid by Los Angeles County and by the state Office of Procurement of the Department of General Services. (Appendix A details the methodology used in this cost analysis.) We chose Los Angeles County and the Office of Procurement for this comparison because both are government organizations and both contract for drugs. Los Angeles County contracts for drugs used by county hospitals and medical centers while the Office of Procurement contracts for drugs used by state hospitals and correctional institutions. Currently, Los Angeles County spends approximately $15 million on drugs and the Office of Procurement expends $3 million; DHS, however, spent $96 million during 1977-78 fiscal year on Medi-Cal drugs exclusive of dispensing fees.

According to our analysis, Medi-Cal paid $21.6 million during fiscal year 1977-78 for the 30 most highly reimbursed multi-source prescription drugs, exclusive of dispensing fees. If DHS had contracted for these drugs and had obtained prices similar to those obtained by Los Angeles County or the state Office of Procurement, DHS could have saved

Medi-Cal $6.2 to $7.3 million in ingredient costs. (Appendix B compares the three organizations' ingredient costs of the 30 most highly reimbursed drugs.)

Table 1 presents a comparison of the ingredient costs of five of the prescription drugs as purchased by Medi-Cal, Los Angeles County, and the state Office of Procurement.

TABLE 1

INGREDIENT COST COMPARISON OF
FIVE PRESCRIPTION DRUGS PER 100 TABLETS

Name	Strength	Quanity Dispensed for Medi-Cal	Medi-Cal	Los Angeles County	Office of Procurement	Savings Available per 100 Tablets
Hydrochloro-thiazide	50 mg	23,192,746	$ 3.54	$ 1.70	$ .94	$ 1.84 - $ 2.60
Amitriptyline	50 mg	7,258,852	$14.43	$ 4.20	$6.55	$ 7.88 - $10.23
Meclizine Hydro-chloride	25 mg	7,834,839	$ 6.75	$ 1.66	$1.35	$ 5.09 - $ 5.40
Ampicillin	500 mg	3,784,301	$14.74	$ 6.82	$6.42	$ 7.92 - $ 8.32
Amitriptyline, Hydrochloride, Perphenazine	2mg-25mg	7,350,788	$11.42	$ 4.20	$4.60	$ 6.82 - $ 7.22

Because of the department's attempt in 1977 to volume purchase prescription drugs, various DHS officials estimate it will cost at least $600,000 annually to implement a volume purchasing system for drugs. This figure includes the estimated costs of system design, claims processing, electronic

data processing, contract processing, regulation implementation, and program management. The estimate does not, however, include the costs of additional quality control or legal services.

By purchasing the 30 multi-source drugs in volume and by obtaining prices comparable to those paid by Los Angeles County or by the state Office of Procurement, DHS could save approximately 29 percent to 34 percent in ingredient costs, yielding an estimated net annual program savings of $5.6 to $6.7 million.

Provider Concerns Regarding Volume Purchasing Prescription Drugs

Both the Pharmaceutical Manufacturers' Association (PMA) and the California Pharmacists' Association (CPhA) have expressed reservations about DHS' volume purchase proposal. PMA predicts that volume purchasing will decrease quality control and research and development; this association also cited that volume purchasing will favor the small generic firms and practically eliminate the larger research-based companies. Furthermore, PMA stated that since physicians will not allow a substitute for the contracted drug, the program may not be effective.

According to the California Pharmacists Association, prescription drug prices will increase and patients not eligible for Medi-Cal will have to pay for the program. CPhA is concerned that volume purchasing proposals do not include provisions to assure that the contractor will be able to provide sufficient quantities nor do current proposals reflect alternative means of meeting patient needs in the event that the contractor is unable to meet demand. The California Pharmacists Association also objects to the department's proposal to stipulate which brand is acceptable without assuming liability for the substitution. To evaluate the validity of these potential problems, CPhA requests that DHS implement a pilot project before instituting a statewide program.

Potential Savings Through
Volume Purchasing Eyeglasses

The Department of Health Services currently pays distributors of eyeglasses and other eye appliances a fee for dispensing and for materials. If contracts were made directly with optical appliance manufacturers for materials and if distributors received only a dispensing fee, DHS could save Medi-Cal approximately $3 million annually.

DHS now provides eyeglasses to Medi-Cal recipients through a maximum reimbursement system. When filling a Medi-Cal prescription, a provider (opthalmologist, optometrist,

or dispensing optician) can obtain eyeglasses in three ways: by purchasing the eyeglasses from a vendor; by purchasing the component parts from multiple manufacturers and then fabricating the eyeglasses; or by manufacturing the lenses, purchasing the frames, and then fabricating the eyeglasses. For these services, DHS pays a provider a usual and customary fee up to a maximum allowance. This fee is designed to reimburse the provider for the material costs and for a dispensing fee. (DHS is not involved with the lens and frame manufacturers during this process.)

Under the volume purchase proposal, the department would contract with lens fabricating laboratories and frame manufacturers to establish set prices for materials. As a result of this process, the provider would be required to use the materials produced by the contracted manufacturers. DHS would still pay the providers a fee for dispensing and reimburse them for the contracted materials but would bill the manufacturers for any excess material costs.

The department analyzed this proposal during February 1979 and computed a potential reduction in provider payments of $2.9 million. This cost analysis did not take into account any additional administrative costs of implementing and operating a volume purchase system.

We analyzed DHS' volume purchase proposal by comparing the average prices currently paid by DHS with those paid by Washington State's Department of Social and Health Services (WASH). WASH has purchased Medicaid eyeglasses in volume for the last five years. Previously, WASH had a maximum allowance system similar to that of California's Department of Health Services.

WASH organized its existing system with the assistance of a professional committee consisting of providers. WASH contracts with a single manufacturer for both lenses and frames. The provider submits a Medicaid prescription to the manufacturer for fabrication. After completing the prescription, the manufacturer mails the eyeglasses to the provider and bills the state directly. The provider dispenses the eyeglasses to the beneficiary and bills WASH only for the dispensing fee. By contracting for eyeglasses, WASH has been able to save substantially on material costs. The following table illustrates these savings; it compares the average prices paid by DHS for single vision eyeglasses and for bifocal vision eyeglasses with those paid by WASH.

TABLE 2

COST COMPARISON OF EYEGLASSES
AS OF FISCAL YEAR 1978-79

		Single Vision Eyeglasses		Bifocal Vision Eyeglasses
California's Average Costs		$43.20		$57.28
Washington's Contracted Costs				
Material Costs	$20.55		$27.65	
Dispensing Fees	14.80		14.80	
Total		$35.35		$42.45
Difference		$ 7.85		$14.83

According to our analysis, DHS would have paid $16.1 million in dispensing fees and material costs rather than $19.3 million during fiscal year 1978-79 if it had obtained the contracted prices of WASH. This calculation does not include the department's additional administrative costs of implementing and operating a volume purchase system.

To determine administrative costs, we requested that DHS officials estimate the additional administrative costs of implementing and operating a volume purchase system for eyeglasses. Various DHS officials estimate it would cost at least $240,000 to implement new regulations, process the contracts, design the system, and perform additional quality control. The department could not estimate the costs of claim

processing, legal services, and general program management. Including estimated administrative costs, the program would have cost approximately $16.3 million, for a savings of $3.6 million.

Provider Concerns Regarding Volume Purchasing Eyeglasses

California's Association of Dispensing Opticians has expressed concern about volume purchasing eyeglasses. The association fears that the market will become more concentrated through volume purchasing. According to this provider group, two firms now control 50 percent of the optical sales by manufacturers and 80 percent of the sales by wholesale optical laboratories. The Association of Dispensing Opticians thinks this concentration violates the spirit of the federal antitrust laws.

The opticians maintain that dispensing eyeglasses involves satisfying an individual's unique needs by fitting that individual with custom-made lenses rather than by dispensing a ready-made commodity. The association contends that the department has erred in its assumption that by purchasing eyeglasses in volume, it will still maintain quality products.

Currently, some opticians can manufacture certain lenses and fabricate eyeglasses in their offices when time permits. Because volume purchasing will require a contractor to fabricate all Medi-Cal eyeglass prescriptions, the opticians feel their business would become less efficient. Without direct control over the manufacturing process, the opticians foresee resolving problems with products as an increasing responsibility which will create more paperwork and more administrative problems.

The California Optometric Association does not have any major objections to the volume purchase proposal. The optometrists tentatively favor such a program, providing it controls the quality of fabricating laboratories and includes a reasonable dispensing fee.

Potential Savings Available Through Volume Purchasing Laboratory Tests

The Department of Health Services now pays qualified providers a fee for conducting laboratory tests. Under this system, the department paid $50.6 million for laboratory tests during 1978. Analysis of these costs indicates the department could save the Medi-Cal program as much as $7.5 million annually by contracting with specific laboratories for certain nonemergency outpatient tests.

Physicians order laboratory tests for Medi-Cal beneficiaries and use test results to diagnose or detect disease and to evaluate patients' response to treatment. Technicians perform tests in independent laboratories, hospital laboratories, and physicians' offices on an emergency or nonemergency basis for hospital inpatients and outpatients.

Clinical laboratories can achieve cost savings through the use of automated testing equipment and sophisticated transportation networks. One such laboratory receives specimens in Burlingame, flys them to New Jersey, performs the test, and transmits results to physicians by satellite and computer within 24 hours. At the time of our review, this laboratory charged $4.60 for a pap smear (a common type of laboratory test). During November 1979, the department paid an average of $6.22 for this test but would reimburse laboratories up to a maximum of $8.70.

In February 1979, DHS analyzed potential cost savings through contracting with selected high volume laboratories for Medi-Cal tests and concluded that such contracts could save the State $8 million in payments to physicians and clinical laboratories annually. This analysis did not include hospital laboratory tests.

The department compared the average and lowest prices paid for laboratory tests and found some instances where this difference was as much as 60 percent. An outside consultant then identified tests that could not be contracted to high volume laboratories because of technical considerations (such as special handling or timeliness). The consultant also specified tests which could be automatically processed to achieve the highest cost savings. In its analysis, the department concluded that costs for 76 of the more than 900 laboratory procedures would decrease through the use of centralized testing contracts. DHS assumed that a 30 percent discount could be achieved and thus calculated an annual program savings of $8 million. This calculation did not include the costs of administration.

Although we did not perform a detailed review of the department's analysis, we discussed its methodology and conclusions with other individuals having expertise in the laboratory services industry. These individuals indicated the analysis was reasonable and that the use of automated equipment could reduce the cost of certain laboratory tests; we agree with this assessment.

We applied the department's methodology to November 1979 payment data to obtain an estimate of savings available. We then subtracted the costs of six positions which the

department stated are needed to administer laboratory services contracts. As a result of this calculation, we concluded that the Medi-Cal program could save $7.5 million through contracting.

Provider Concerns Regarding Contracting for Laboratory Services

We discussed the proposal for contracting with laboratories for certain outpatient tests with a representative of the California Clinical Laboratory Association. He concurred with our conclusion that the analysis conducted by the Department of Health Services appeared reasonable and that the department would save money by implementing this proposal.

Nevertheless, the representative stated the disadvantages of such a proposal. Market concentration could increase if small laboratories lost a significant amount of their business. Also, state administrative costs would rise. Since laboratories are already licensed by the State, the representative felt that additional contract monitoring would be unnecessary. The representative further suggested that the State allow out-of-state laboratories to bid to ensure competition for contracts. The program should also include some controls to ensure that physicians use the contract laboratories for all appropriate cases.

Legal Constraints to Implementing Volume Purchasing Projects

During the course of our review, we noted certain legal issues restricting the ability of DHS to implement volume purchasing. One of these issues relates to Medi-Cal recipients' freedom to choose between providers of medical services as provided under state and federal law. Also, volume purchasing of drugs cannot interfere with customary distribution practices in the drug industry. We requested the opinion of the Legislative Counsel to clarify these issues. (Appendix C contains this opinion in its entirety.) The following is a summary of the Legislative Counsel opinion.

Federal law states that Medi-Cal beneficiaries shall have freedom to choose between providers of medical services. The federal Department of Health, Education, and Welfare can waive this requirement if a state seeks to institute a demonstration project.* State law also contains a similar freedom of choice doctrine.

Freedom of choice does not prohibit volume purchase plans for prescription drugs and eyeglasses. These plans affect relationships between manufacturers, wholesalers, and

* The Department of Health, Education, and Welfare accepts waiver applications semi-annually and can take six months or longer to approve them.

providers. Because clinical laboratories provide services directly to beneficiaries, this doctrine does prohibit contracting for laboratory services statewide. However, if DHS obtained a federal waiver, it could implement a pilot project in this area.

According to the Legislative Counsel, Section 14105.3 of the Welfare and Institutions Code allows DHS to contract for prescription drugs provided that this procedure does not interfere with usual and customary distribution practices in the drug industry. The Legislative Counsel believes a volume purchase rebate plan for prescription drugs that does not bypass the normal chain of distribution would not violate this section. Therefore, the Legislative Counsel concludes that the department presently has the power to institute such a plan. Because of this section, DHS needs state legislative authorization to implement volume purchasing for eyeglasses and laboratory services. However, the department may implement pilot projects without such authorization. Table 3 summarizes the legal constraints which restrict DHS' ability to implement volume purchasing programs.

TABLE 3

SUMMARY OF LEGAL CONSTRAINTS
TO VOLUME PURCHASING

Pilot Projects	Prescription Drugs	Eye Appliances	Laboratory Services
State legislation needed?	No	No	No
Federal freedom-of-choice waiver needed?	No	No	Yes
Statewide VPP			
State legislation needed?	No	Yes	Yes
Federal legislation needed?	No	No	Yes

To implement volume purchasing, DHS must consider these constraints. In some cases, the department must obtain legislative or administrative approval for its volume purchasing proposals.

CONCLUSION

If a statewide system were implemented to volume purchase prescription drugs, eyeglasses, and laboratory services, the Department of Health Services could save Medi-Cal approximately $16.1 million annually. Other government organizations in California and in other states have successfully instituted volume purchasing plans. But some aspects of this proposal require careful evaluation. Provider groups, for example, have a number of

concerns related to state administration of volume purchasing and its effects on their markets. In some instances, state legislation or federal waivers of freedom-of-choice requirements would be required for implementation of volume purchasing.

RECOMMENDATION

We recommend that the Department of Health Services implement pilot projects for volume purchasing prescription drugs, eyeglasses, and laboratory services for Medi-Cal beneficiaries. The department should coordinate its efforts with those of the state Office of Procurement within the Department of General Services. Each pilot project should evaluate the barriers to volume purchasing, such as administrative procedures and provider concerns. Specifically, the Department of Health Services should implement pilot projects for prescription drugs, eyeglasses, and laboratory services as detailed below:

Prescription drugs

The department should implement a pilot project for prescription drugs. This project should contain rebate agreements with pharmaceutical manufacturers

for a limited number of common, multi-source drugs. The project evaluation should consider administrative costs, utilization and availability of products, and market effects.

Eyeglasses

The department should implement an eyeglass pilot project in a representative geographical region of the State. The project design should include agreements with fabricators for materials and agreements with providers for dispensing fees. These agreements could be patterned after those of the system in the State of Washington. The project evaluation should consider administrative costs, compare the present system's costs of materials and dispensing services with those of the pilot project, and evaluate market effects.

Laboratory services

Finally, we recommend the department implement a laboratory services pilot project which contracts for a limited number of common, nonemergency outpatient lab tests in one representative geographical region of the State. To begin this project, DHS should first obtain necessary waivers of freedom-of-choice requirements contained in federal law. The

evaluation should consider administrative costs, develop criteria for identification of tests suitable for contracting, and analyze changes in the proportions of tests classified as emergency as opposed to those classified as nonemergency.

In designing and evaluating the projects, DHS should consider providers' concerns relating to the program. DHS should determine the validity of these concerns and develop recommendations for dealing with such concerns should the systems be implemented statewide.

If the department determines that volume purchasing is feasible and results in cost savings, it should request that the Legislature authorize the implementation of volume purchasing statewide. In addition, DHS should work to amend federal legislation to exercise such authority.

Respectfully submitted,

Thomas W. Hayes

THOMAS W. HAYES
Auditor General

Date: April 10, 1980

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STATE OF CALIFORNIA—HEALTH AND WELFARE AGENCY EDMUND G. BROWN JR., Governor

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April 8, 1980

Mr. Thomas W. Hayes
Auditor General
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Dear Mr. Hayes:

"COST SAVINGS AVAILABLE THROUGH VOLUME PURCHASING IN THE MEDI-CAL PROGRAM"

Thank you for sharing a draft of the above-mentioned report with the Department of Health Services.

The Department agrees with the basic conclusion of the report that volume purchasing is a proven approach to cost savings which can result in substantial savings for the Medi-Cal program. We concur with your recommendations that pilot projects are the appropriate next step to pursue volume purchasing.

As recounted in your report, the Department has for many years actively supported volume purchasing concepts. Our current approaches to pilot projects have evolved over the years from specific studies and from our desire to be responsive to valid concerns expressed by various provider groups. We are gratified to note that the report supports our current approaches for pilot projects.

There are two specific, technical notes deserving of comment. First, the savings projected by your staff for an eye appliance volume purchase arrangement is comparable to the Department's projection despite the fact that the two projections were computed on a somewhat different series of assumptions. This comparability should add a measure of confidence to these projections. Second, the methodology used in the report to compute the savings on a drug volume purchasing arrangement is a conservative one with a bias toward underestimating the cost savings. The actual savings are likely to be higher. However, no approach for this computation is without its bias and we support the approach used by your staff as the most logical one available.

In closing, I wish to point out an additional benefit to the State of volume purchase arrangements which was not discussed in the draft report. Volume

purchase arrangements hold significant potential to combat a number of abuses now experienced by the Medi-Cal program, particularly in relation to laboratory services, and to curtail a number of current drug pricing practices which now work to the detriment of the Medi-Cal program.

I look forward to the issuance of the final report.

Sincerely,

Barry S. Dofrman

Barry S. Dofrman, M.D.
Assistant Director for
Program Integrity

COST ANALYSIS METHODOLOGY

This section explains the methodology we used to compare commodity costs. The first section explains our analysis of volume purchasing for prescription drugs and the second section, a similar analysis for eyeglasses.

Comparison of the Ingredient Costs of Prescription Drugs

We compared the ingredient costs paid by the Department of Health Services for Medi-Cal drugs with those costs paid by Los Angeles County and the state Office of Procurement of the Department of General Services.

We selected the drugs for analysis by scanning the Department of Health Services' Annual Summary Report of Drug Usage by Amount Paid for fiscal year 1977-78 and by selecting the 30 most highly reimbursed drugs which were supplied by more than two manufacturers. The drugs selected had to appear on the list of potential volume purchase drugs established by DHS. For each of the 30 drugs, we extracted the name, strength, formulary code number, amount paid, number of prescriptions, and quantity dispensed from the drug usage report.

We next computed the total dispensing fees paid for each drug by multiplying the number of prescriptions filled by the unit dispensing fee. We computed the total ingredient cost by subtracting the total dispensing fees from the total amount paid. By dividing total ingredient costs by the quantity dispensed, we computed ingredient costs per tablet or per cubic centiliter (cc).

A pharamacist from DHS' Benefits Section selected comparable drugs from Los Angeles County's drug contract and from the state Office of Procurement's drug contract.* Both

* Los Angeles County's contract was effective from January 1, 1978 to December 31, 1978 while Procurement's was effective from October 20, 1977 to October 19, 1978.

contracts listed prices effective as of June 30, 1978. Unit dosage prices were excluded unless no other price was available; otherwise, the highest price was used. The selected contract price was then converted to the price per tablet or per cc. To compute the potential savings per drug type, we multiplied the difference between DHS' unit ingredient costs and Los Angeles County or state Office of Procurement unit prices by the quantity dispensed. The total potential savings in ingredient costs were $6.2 million and $7.3 million. We excluded from the analysis instances in which DHS' unit cost was less than Los Angeles County's or Procurement's unit costs.

Comparison of Payments for
Eyeglasses to Providers

We also compared the costs of California's DHS Medi-Cal eyeglass program with those costs paid by Washington State's Department of Social and Health Services' Medicaid program. Washington's department has contracted for eyeglasses since September 1975. We compared the costs of these two agencies because their programs provide similar benefits and charge comparable prices. Specifically, charges in Seattle are comparable to those in Los Angeles and the San Francisco-San Jose area.

We summarized the monthly data from DHS' Health Statistics' printout (HUMR60B) for the 12 months ended June 30, 1979. This printout reports by procedure code the unit of service, the amount billed, and the amount allowed (reimbursed by DHS).* From this report we calculated the total units of service, the total amount reimbursed by DHS, and the average amount paid per unit of service. We then substituted WASH's contracted unit prices for DHS' prices whenever possible.** If no WASH price was available, we used current costs paid by DHS.

To calculate dispensing fees, we assumed all the frames and frame fronts were distributed as eyeglasses and required a full dispensing fee of $14.80. This assumption reduced the available lenses by one pair per frame or frame

* Each procedure code has a maximum allowance designed to cover material costs and dispensing fees.

** The WASH contract included a range of frame prices. We used the highest price.

front. We assumed that the remaining frame components and lenses were distributed as repairs. In this case, we allowed the highest repair dispensing fee of $10.00.

Our analysis yielded a total of $9.1 million in material costs and $7.0 million in dispensing fees. If WASH's contracted prices were available to DHS, total payments to providers for eyeglasses would have been $16.1 million as compared to $19.3 million. This difference amounts to a decrease in provider payments of approximately $3.2 million.

PRESCRIPTION DRUGS
COMPARISON OF INGREDIENT COSTS
PER 100 TABLETS OR 100 CUBIC CENTILITERS

	Name	Strength	Medi-Cal	Los Angeles County	Office of Procurement
1.	Aspirin, Phenacetin, and Caffeine with Codeine	.5gr	$ 6.59	$ 5.50	*
2.	Aspirin, Phenacetin, and Caffeine with Codeine	1gr	$13.14	*	*
3.	Aluminum and Magnesium Hydroxide Liquid with Simethicone	--	$ .62	*	$ .06
4.	Tetracycline	250mg	$ 2.21	$ 2.50	$1.70
5.	Erythromycin	250mg	$ 7.79	$13.76	$5.49
6.	Potassium Chloride Liquid	10%-20%	$ .26	$ .14	$ .14
7.	Tripolidine and Pseudoephedrine	--	$ 3.60	$ 4.16	$1.48
8.	Hydrochlorothiazide	50mg	$ 3.54	$ 1.70	$ .94
9.	Amitriptyline	50mg	$14.43	$ 4.20	$6.55
10.	Aluminum Magnesium Hydroxide Gel	--	$ .43	$ .03	*
11.	Phenytoin	100mg	$ 2.00	$ .61	$1.26
12.	Amitriptyline	25mg	$ 8.18	$ 2.60	$3.60
13.	Pencillin VK	250mg	$ 5.12	$ 3.45	*
14.	Amitriptyline Hydrochloride, Perphenazine	2mg-25mg	$11.42	$ 4.20	$4.60

* No comparable price available.

	Name	Strength	Medi-Cal	Los Angeles County	Office of Procurement
15.	Ampicillin Solution	250mg/5cc	$ 1.91	$1.04	$1.35
16.	Quinidine Sulfate	3gm	$ 8.89	$5.85	$5.80
17.	Ferrous Sulfate	5gm	$ .57	$ .17	$ .55
18.	Hydrogenated Ergot Alkaloids	.5mg	$ 8.56	*	$4.50
19.	Digoxin	.25mg	$ .28	$ .68	*
20.	Ampicillin	250mg	$ 7.47	$7.75	$4.44
21.	Promethazine Expectorant Liquid with Codeine	--	$ .71	*	$ .75
22.	Dimetapp Liquid	--	$ .73	*	*
23.	Ampicillin	500mg	$14.74	$6.82	$6.42
24.	Belladonna Alkaloids with Barbituates		$ .50	$ .17	$ .60
25.	Chloral Hydrate	500mg	$ 1.80	*	$1.39
26.	Tolbutamide	500mg	$ 8.84	$9.48	$9.48
27.	Meclizine Hydrochloride	25mg	$ 6.75	$1.66	$1.35
28.	Triprolidine and Pseudoephedrine Liquid	--	$ .73	$ .81	$ .30
29.	Triamcinolone Cream	.025%	$ 4.40	$1.63	$2.27
30.	Diphenoxylate Hydrochloride with Atropine	2.5mg	$ 8.86	$1.44	$ .20

* No comparable price available.

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APPENDIX C

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Sacramento, California
February 11, 1980

Mr. Thomas W. Hayes
Auditor General
925 L Street, Suite 750
Sacramento, CA 95814

Volume Purchasing by Department of Health Services - #18114

Dear Mr. Hayes:

You have asked the following question regarding the authority of the Department of Health Services to engage in certain volume purchasing plans under the Medi-Cal program.

QUESTION

Is the Department of Health Services authorized under existing law to enter into contracts on a bid basis with manufacturers, distributors, dispensers, or suppliers of drugs, appliances, durable medical equipment, medical supplies, and other products-type health care services provided to Medi-Cal beneficiaries? Could the department establish a durable medical equipment pool or contract on a bid basis with medical testing laboratories? If not, is the department authorized to do so as a pilot project?

OPINION

Except for the provision of drugs under certain circumstances, including such conditions as those set forth in the plan for volume purchasing of drugs as described by your office, the Department of Health Services lacks the authority under existing law to contract on a bid basis with manufacturers, distributors, dispensers, or suppliers of appliances, durable medical equipment, medical supplies, and other products-type health care services which are provided to Medi-Cal recipients. Furthermore, the Department of Health Services is not authorized to enter into exclusive contracts with providers of laboratory services to contract with providers of laboratory services. Authority is also lacking to form a durable medical equipment pool. Under most circumstances, however, it would be feasible for the Department of Health Services to undertake pilot projects. In certain instances, however, such as the forming of the durable medical equipment pool and centralized provision of laboratory services, it would be necessary to obtain waivers from the federal government to initiate such projects.

ANALYSIS

In recent years plans have been proposed which would permit the Department of Health Services to contract with manufacturers, or other entities, for the purchase of specified products or the provision of specified services from manufacturers or other entities, or to give such entities the exclusive right to sell such products or provide such services in order to achieve reduced prices, either through volume purchasing or exclusive sale arrangements.

This opinion discusses the legality of such plans under existing state and federal statutes.

Existing law would permit the Department of Health Services to contract for the provision of drugs on a bid basis, under certain limited circumstances.

Section 14105.3* provides:

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* Sections referred to are in the Welfare and Institutions Code.

> "14105.3. The department is considered to be the purchaser, but not the dispenser or distributor, of prescribed drugs under the Medi-Cal program for the purpose of enabling the department to obtain from each manufacturer of prescribed drugs the most favorable price for such drugs furnished by that manufacturer, based upon the large quantity of such drugs purchased under the Medi-Cal program, and to enable the department, notwithstanding any other provision of California law, to obtain from such manufacturers discounts, rebates, or refunds based on such quantities purchased under said program, insofar as may be permissible under federal law. Nothing in this section shall interfere with usual and customary distribution practices in the drug industry."

This section allows the Department of Health Services to enter into contracts for the purchase of drugs on a bid basis in order to achieve reduced prices as long as such arrangements do not interfere with usual and customary industry distribution practices.

As we understand it, under usual and customary practices of the industry, drugs are provided by manufacturers to wholesalers, who in turn supply them to pharmacies for sale to the general public. Occasionally, the manufacturer sells directly to the pharmacy. In our opinion volume purchasing plans which do not bypass this chain of distribution would not interfere with usual and customary drug industry distribution practices.

The proposed plan for the provision of drugs, as outlined by your office, would not violate such practices. Under this plan, the state would enter into contracts with drug manufacturers through the use of competitive bids, with the contract being awarded to the manufacturer who provides the lowest net cost for specified drugs. Drugs would be sold by the manufacturers either directly to pharmacies, or to wholesalers, who would in turn sell them to pharmacies. Pharmacies would have to buy the state-designated brand, and the state would receive rebates from drug manufacturers.

We have been informed by your office that under many volume purchasing plans, such as the one described by your office, the pharmacist will have no choice concerning

which brand of a drug must be delivered in order for the pharmacist to obtain Medi-Cal reimbursement. It may be argued that this violates the provision against interfering with usual and customary distribution practices. This restriction, however, does not imperil the use of the normal distribution chain of the drug industry, and, therefore, we think it does not violate state law.

It has often been argued, however, that the freedom of choice doctrine, as set forth in the Social Security Act (42 U.S.C.A. Sec. 1396a(a)(23), prohibits such contracts. That provision states:

> "(23) except in the case of Puerto Rico, the Virgin Islands, and Guam, provide that any individual eligible for medical assistance (including drugs) may obtain such assistance from any institution, agency, community pharmacy, or person, qualified to perform the service or services required (including an organization which provides such services, or arranges for their availability, on a prepayment basis), who undertakes to provide him such services; and a State plan shall not be deemed to be out of compliance with the requirements of this paragraph or paragraph (1) or (10) solely by reason of the fact that the State (or any political subdivision thereof) has entered into a contract with an organization which has agreed to provide care and services in addition to those offered under the State plan to individuals eligible for medical assistance who reside in the geographic area served by such organization and who elect to obtain such care and services from such organization, or by reason of the fact that the plan provides for payment for rural health clinic services only if those services are provided by a rural health clinic;"

This section provides that Medicaid recipients shall have freedom to choose between providers of services under Medicaid programs (see Dist. of Col. Pod. Soc. v. District of Columbia, 407 F. Supp. 1259, 1266).

State law also contains a freedom of choice doctrine. Section 14105 of the Welfare and Institutions Code provides that, insofar as is possible, recipients shall have free choice of medical arrangements.

Prior litigation has held that New York City was probably violating the freedom of choice doctrine by contracting for laboratory services, instead of allowing recipients to choose between providers of such services (Bay Ridge Diagnostic Laboratory, Inc. v. Dumpson, 400 F. Supp. 1104 (E.D.N.Y., 1975)). The Department of Health, Education, and Welfare has taken the position that centralized purchasing will not violate the freedom of choice doctrine when the state itself, or by contract, provides products to qualified vendors, instead of directly to recipients (GAO Report No. HRD 78-60, July 6, 1978, cited at CCH Medi-Care-Medicaid Guide, Sec. 29,109). This interpretation of the freedom of choice doctrine would allow volume purchasing of drugs as long as the drugs are provided to qualified vendors, i.e., pharmacies, and not directly to Medi-Cal recipients.

There is no reason to declare that the freedom of choice doctrine, as codified under state law, will be interpreted differently from its federal counterpart.

It may be argued that a conflict exists between Section 14105, which requires that rates of payment may only be set through promulgation of regulations, and Section 14105.3, which allows volume purchasing arrangements for drugs. Again, however, interpreting the statute as a whole, the grant of authority under Section 14105.3 will be viewed as an exception to the general rule as stated in Section 14105.

Under the proposed plan for volume purchasing of drugs, as described by your office, drugs would still travel through the normal distribution chain from the manufacturers to the pharmacies. Thus, there would be no interference with usual and customary practices of the drug industry. Furthermore, since drugs would not be provided directly to recipients, no violation of the freedom of choice doctrine exists. Therefore, in our opinion, the Department of Health Services has the power to institute such a plan for the provision of drugs.

Authority is lacking, however, to institute volume purchasing programs for medical supplies and other products-type services, including eye glasses, wheelchairs, and oxygen. Not only is there a lack of general authority in the statutes relating to the medical assistance program to undertake volume purchasing plans, but the exception for volume purchasing of drugs in Section 14105.3 implies that a particular method of purchasing such as that proposed may only be used when specifically authorized by the Legislature. Furthermore, Section 14105 states that rates of payment shall only be

reached through regulation. If a volume purchasing program were to be instituted, rates of payment would be reached through bidding and negotiation. An exception to this rule, either explicit or implicit, such as the one which has been previously noted as deriving from Section 14105.3, would be necessary in order to institute volume purchasing plans for products-type services.

The Department of Health Services, however, has broad power to undertake pilot projects, and such power would clearly be sufficient to commence volume purchasing plans on a pilot basis. Sections 14490 to 14498, inclusive, provide authority under which the Department of Health Services may institute pilot programs. One of the aims of such a program, as defined in Section 14490, is to develop alternate forms of financing and methods of health care delivery. Section 14494 provides, in pertinent part:

> "14494. The director may enter into other contracts under this article which do one or more of the following:
>
> * * *
>
> "(e) Stress a more economical organization of health care resources and delivery systems.
>
> "(f) Provide an incentive to beneficiaries to seek the most economical level of care.
>
> * * *"

The broad powers granted under the section would most certainly permit the commencement of volume purchasing programs on a pilot project basis. Pilot projects for any type of product or service, must, of course, not violate federal law. As previously discussed, the limitation which federal law presents is based on the freedom of choice doctrine, which permits volume purchasing plans only insofar as they provide products to qualified vendors, instead of directly to recipients. Even if a plan were sought to be

instituted which did seek to provide products directly to recipients, it would probably be possible to undertake such a demonstration project under federal law. Section 1315 of Title 42 of the United States Code Annotated provides that where a state seeks to institute a demonstration project under various programs, including Medicaid, the state may seek waiver of requirements from the Secretary of the Department of Health, Education, and Welfare. If, therefore, the state does seek to institute a plan whereby the state will provide product services directly to recipients, a federal waiver could be sought. Addressing the plans described by your office for the provisions of eyeglasses, wheelchairs, and oxygen, therefore, a pilot project could be undertaken without need of a federal waiver as long as neither the state nor the supplier of the product was providing the product directly to recipients.

Not only does authority under state law not exist to operate a durable medical equipment pool, but such a pool would also violate the federal freedom of choice doctrine, since the state would provide equipment directly to recipients. Due to this apparent violation of federal law, the operation of a durable medical equipment pool could not even be commenced upon a pilot project basis unless a waiver was obtained from the Department of Health, Education, and Welfare.

The Department of Health Services lacks specific authority to enter into exclusive bid contracts for the provision of laboratory services. As previously noted, except for the provision of drugs, no specific authority has been granted to allow centralized purchasing of products or services under existing state statutes. Furthermore, since centralized provisions of laboratory services would arguably amount to a situation where services were being provided directly to recipients instead of to qualified vendors (i.e., Bay Ridge Diagnostic Laboratories, Inc. v. Dumpson, supra), such a program would violate the freedom of choice doctrine. If such services were to be instituted upon a pilot project basis, the freedom of choice doctrine would necessitate the acquisition of a federal waiver.

In summary, except for the provision of drugs under certain circumstances, including such conditions as those set forth in the plan for volume purchasing of drugs as described by your office, the Department of Health Services lacks the authority under existing law to contract on a bid basis with manufacturers, distributors, dispensers, or suppliers of appliances, durable medical equipment, medical supplies, and other products-type health care services which are provided to Medi-Cal recipients. Furthermore, the Department of Health Services is not authorized to enter into exclusive contracts with providers of laboratory services. Authority is also lacking to form a durable medical equipment pool. Under most circumstances, however, it would be feasible for the Department of Health Services to undertake pilot projects. In certain instances, however, such as the forming of the durable medical equipment pool and centralized provision of laboratory services, it would be necessary to obtain waivers from the federal government to initiate such projects.

Very truly yours,

Bion M. Gregory
Legislative Counsel

By Jeff Thom
Jeff Thom
Deputy Legislative Counsel

JT:jp

cc: Honorable S. Floyd Mori, Chairman
Joint Legislative Audit Committee

cc: Members of the Legislature
Office of the Governor
Office of the Lieutenant Governor
Secretary of State
State Controller
State Treasurer
Legislative Analyst
Director of Finance
Assembly Office of Research
Senate Office of Research
Assembly Majority/Minority Consultants
Senate Majority/Minority Consultants
California State Department Heads
Capitol Press Corps